

SEC Gears Up For Another Look At Private Offering Rules

By Tom Zanki

Law360 (June 18, 2021, 6:25 PM EDT) -- The U.S. Securities and Exchange Commission appears ready to once again review private offering rules, backed by a new Democratic majority that could favor stronger requirements than those enacted by the prior Republican-led commission.

The SEC plans to seek comment on whether it should revise accredited investor thresholds, which determine who is eligible to invest in private securities offerings, according to a near-term agenda outlined June 11 by chairman Gary Gensler.

The SEC is also considering seeking more information regarding private offerings completed under Regulation D, which is the largest exemption relied upon by companies raising private capital. Private offerings are exempt from the normal registration requirements of securities laws, thus providing less disclosure and affording investors fewer rights than public offerings.

The agenda does not suggest rule proposals are imminent. The SEC's Division Of Corporation Finance is considering recommending that the agency seek public comment on the topics, which could set the stage for rulemaking. Comments could be requested by April.

The SEC appears to be stepping up oversight of private capital markets — which have grown to exceed public markets — quickly after the prior administration revised regulations governing unregistered securities. The SEC's Republican majority last year made modest changes that would expand the pool of accredited investors, allowing for further private market growth.

Both Democratic commissioners criticized the SEC's action at the time, saying regulators missed an opportunity to address risks to investors posed by enlarged private markets. Now that Democrats have a 3-2 edge, they could have the votes to beef up investor protection.

"The ideas the Democrats raised in their dissents may have some legs," said Covington & Burling LLP counsel David Martin, a former Division of Corporation Finance director at the SEC.

The new SEC's priorities have rankled the commission's two Republicans. Commissioners Hester Peirce and Elad Roisman in a joint statement June 14 took issue with Gensler's agenda, concerned that the new leadership wants to undo rules that have just taken effect. They mentioned the decision to revisit the accredited investor definition and additional rules affecting exempt offerings, among other things.

"A change in administration naturally brings changes in policy ... but reopening large swathes of work that was just completed without new evidence to warrant reopening is not normal practice," Peirce and Roisman said.

Democratic commissioners Allison Herren Lee and Caroline Crenshaw objected to the prior SEC's actions regarding accredited investors on various grounds, including that regulators did not adjust financial thresholds for inflation going forward. They worried that this would further expand private markets as more people become accredited investors as their wealth grows over time.

An accredited investor is typically defined as someone who earns at least \$200,000 a year or owns at least \$1 million in net worth excluding their primary home's value. The thresholds were set in 1982 and never adjusted for inflation. Last year's SEC left those standards unchanged and widened the definition to include people who hold certain credentials, such as brokers licenses.

In a recent speech, Lee favored "modernizing" the accredited investor definition to protect individuals from the reduced transparency and other risks involved with private offerings. SEC data shows that about 13% of the population is now eligible to be accredited investors, compared to 2% of the population in 1983, mainly because standards were never adjusted for inflation.

"We should update the thresholds and index them for inflation going forward," Lee told the North American Securities Administrators Association in the May 21 speech.

Lee also said the SEC needs to gather more data regarding Regulation D offerings to inform its policies. SEC data shows that \$2.7 trillion was raised in private offerings in 2019, compared with \$1.2 trillion in registered offerings. Most private capital is raised through Regulation D, which allows Silicon Valley startups and other large entities to raise unlimited funds from accredited investors.

Companies that raise money through such offerings typically fill out a Form D, which is not required and provides little information compared with a full-blown registration statement. Some investor groups worry that regulators are operating with scant information about the Regulation D market.

"We don't have reliable statistics about who raises capital there, how well those offerings succeed, how they perform for investors, whether they promote long-term capital formation and job creation or promote the churn and burn of job creation and job destruction all too common among small startup companies," said Barbara Roper, director of investor protection at the Consumer Federation of America. "Furthermore, these markets have been a major source of investor abuses, according to NASAA statistics year in and year out."

Any further review of exempt offerings is likely to renew robust debate, which has been occurring for years now that private capital markets have become too large to ignore.

Some business groups have reservations about raising thresholds to participate in private investments, given wide disparities in income and living costs around the country, which tend to favor the wealthier East and West coasts. Plus, the idea of defining an accredited investor largely according to wealth without considering sophistication is a sticking point.

Tom Quaadman, executive vice president at the U.S. Chamber of Commerce's Center for Capital Markets Competitiveness, said last year's SEC's actions broadening the accredited investor eligibility were steps in the right direction.

Quaadman added that he favors more discussion and information gathering, but said there needs to be

stability in rulemaking so market participants know what to expect.

"We think it's important, to some degree, for the SEC to see how things are working for a period of time before going back and making changes," Quaadman said. "One thing we don't want to have in the marketplaces is rules that change from administration to administration."

Another factor drawing more attention to private marketplaces is that legislation like the Jumpstart Our Business Startups, or JOBS, Act of 2013 eased certain communication restrictions governing Regulation D and other private placements. Plus, the growth of internet and social media has made it easier for people to learn about private offerings, a risk that Lee and Crenshaw mentioned in their dissent from last year's action to expand the accredited investor definition.

They expressed concern that senior citizens and other unsuspecting investors could be targeted for private securities sales that lack protections afforded by registered offerings.

Locke Lord LLP partner Rob Evans noted that the SEC's emphasis can swing between investor protection and capital formation, both part of the agency's mission, as administrations change.

"This is on their radar screen because they might feel like things have gotten pushed too much in the direction of facilitating capital formation and perhaps the focus on protecting investors should be increased," said Evans, who was a top adviser in the SEC's corporate finance division under prior chairman Jay Clayton.

Evans said one outcome could be that the SEC will limit how much any investor could invest in a single unregistered offering, to protect less sophisticated investors from losing a fortune.

The SEC is also considering reviewing the so-called integration framework that applies to exempt offerings. Integration refers to a securities law doctrine that prevents companies from avoiding registration requirements by stringing together exempt offerings that, when taken together, could be considered a registered offering. The prior SEC eased certain rules regarding integration.

The renewed focus on private offerings also comes after the prior SEC raised annual fundraising limits on smaller, less-used exemptions that may appeal to small businesses that want to raise money through options less costly than a registered offering.

These include crowdfunded offerings, whose annual limits were raised from \$1 million to \$5 million, and Regulation A, which is akin to smaller initial public offerings, where the annual limit increased from \$50 million to \$75 million. Both offerings were promoted by the JOBS Act and both allow sales to non-accredited investors in addition to wealthier investors.

Small-business advocates have often argued for easier rules regarding exemptions and accredited investor requirements, which could be a source of friction as the new SEC turns attention toward investor protection.

"There's a yin and yang to the debate, and it does depend on your point of view going into it," Covington's Martin said.

--Editing by Kelly Duncan and Emily Kokoll.